TAX BULLETIN 02-3

Virginia Department of Taxation

April 8, 2002

ADDITIONAL INFORMATION REGARDING 2001 VIRGINIA INCOME TAX RETURNS

VIRGINIA INCOME TAX FIXED DATE CONFORMITY

On April 8, 2002, Governor Warner signed into law a provision that fixes Virginia's conformity to Internal Revenue Code terminology to the Internal Revenue Code as it existed on December 31, 2001. This bulletin will provide taxpayers with an update to Tax Bulletin 02-2, which addressed the interaction between federal legislation that was recently enacted into law and Virginia's fixed date conformity provision. This bulletin will provide taxpayers with additional information on how to reconcile these legislative developments and reflect them on their 2001 Virginia income tax return. In the future, all updates on fixed date conformity will be published on the department's website at http://www.tax.state.va.us. We encourage you to check the site regularly for additional information on this issue.

This Tax Bulletin supplements Tax Bulletin 02-2 regarding the interaction between the recently enacted "Job Creation and Worker Assistance Act of 2002" ("JCWAA") federal legislation and the fixed date conformity language contained in the Virginia Appropriations Acts for the remainder of FY 02 (HB 29) and the FY 02-04 biennium (HB 30). The House of Delegates and Senate of Virginia have passed both House Bill 29 and House Bill 30, and they are awaiting signature by the Governor.

In Tax Bulletin 02-2, the department advised all Virginia taxpayers that Virginia taxable income should be computed in accordance with federal tax laws as they existed on December 31, 2001. Since the issuance of Tax Bulletin 02-2, the Internal Revenue Service ("IRS") has updated two 2001 income tax forms to reflect the changes made by the JCWAA. This bulletin will instruct all affected Virginia taxpayers on how to reconcile the changes made to the federal forms with their Virginia income tax return.

Changes to the 2001 Federal Income Tax Computation

The JCWAA has two main provisions that affect the calculation of 2001 federal taxable income ("FTI") or federal adjusted gross income ("FAGI"). The first provision is a special 30% depreciation allowance for property acquired after September 10, 2001, and before September 11, 2004. This provision permits a taxpayer to claim an additional first-year depreciation allowance equal to 30% of the adjusted basis of the property after allowing for any Internal Revenue Code ("IRC") § 179 expense allowance. The regular depreciation deduction is then computed on basis of the property less any IRC §179 expense allowance and the special 30% allowance.

In order to account for the special 30% depreciation allowance, the IRS has revised Form 4562, "Depreciation and Amortization," and Form 2106, "Employee Business Expenses." On the revised Form 4562, the IRS added Line 14, "Special depreciation allowance for certain property (other than listed property) acquired after September 10, 2001." On the revised Form 2106, Line 31, "Enter section 179 deduction and special allowance," was changed to indicate that the special 30% depreciation allowance would be included on this line. In addition to the change on Form 2106, the instructions were also updated to reflect that the special 30% depreciation allowance should be taken on Line 31 and that the depreciation limit on Line 36 was raised from $3,060 to $7,660 for all vehicles placed in service between September 11, 2001 and December 31, 2001.

The second provision affecting the calculation of 2001 FTI or FAGI is a provision that changes the treatment of certain discharges of indebtedness of an S corporation. Under the provision, if the debt of an S corporation is discharged in a bankruptcy case or when the S corporation is insolvent, the discharge is excluded from income and any shareholder's basis in the stock of the S corporation is not allowed to increase as a result of this discharge. Under prior law, the discharge was excluded from income, but the shareholder's basis in the stock of the S corporation was allowed to increase. In general, this provision applies to discharges of indebtedness after October 11, 2001.

2001 Virginia Taxable Income Computation for Depreciation

If a taxpayer has previously filed a 2001 income tax return with Virginia that was either computed under the IRC as it existed on December 31, 2001 or included the special addition explained below, then such taxpayer does not need to make an additional filing. All other Virginia taxpayers who have either not filed a 2001 original return or filed a 2001 original return under the current IRC should file the appropriate return consistent with the adjustments detailed below.

For 2001 Virginia income tax purposes, all Virginia taxpayers who have taken the special 30% depreciation allowance or have utilized the increased limit on depreciation for a vehicle used for business purposes will be required to make a special addition on their 2001 Virginia income tax return. This special addition will be equal to the difference between the total amount of depreciation deducted on the taxpayer's 2001 federal income tax return and the total amount of depreciation that the taxpayer would have deducted for federal income tax purposes under the IRC as it existed on December 31, 2001.

Virginia taxpayers who have taken the special 30% depreciation allowance or have utilized the increased limit on depreciation for a vehicle used for business purposes should attach a schedule showing the calculation of the special addition. As an aid to determining the total amount of depreciation that the taxpayer would have deducted for federal income tax purposes under the IRC as it existed on December 31, 2001, the department has created the ***Virginia*** Form 4562 and/or the ***Virginia*** Form 2106. Each of these forms are identical to the 2001 federal Form 4562 and the 2001 federal Form 2106 that were in use prior to the latest IRS revision. These forms can be obtained via the department's website at http://www.tax.state.va.us or by calling (804) 367-8037.

For taxpayers who are using the ***Virginia*** Form 4562 and/or ***Virginia*** Form 2106 to compute their special addition, once each form has been completed, the total depreciation claimed on each of these forms must be subtracted from the total depreciation claimed on the taxpayer's 2001 federal Form 4562 and the 2001 federal Form 2106. The sum of the two differences will be the correct amount of the special addition.

It is important to note that this special addition is not simply an add back of the entire special 30% depreciation allowance taken on the revised federal Form 4562 and/or the revised federal Form 2106. The following example illustrates the proper computation of the special addition.

> **Example 1**: A corporate taxpayer purchases property in November 2001 for $1,000. Under MACRS, the taxpayer is allowed a 10% depreciation deduction on its 2001 return. Under the IRC as it existed on December 31, 2001, the depreciation deduction would be $100 ($1,000 * 10%). Under The JCWAA, the depreciation deduction would be $300 ($1,000 * 30%) plus $70 (($1,000-$300)*10%) or $370. If FTI reported in the 2001 Virginia return includes the JCWAA changes, the taxpayer would need to make an addition of $270 ($370 - $100) to modify Virginia taxable income to reflect FTI pursuant to IRC as it existed on December 31, 2001.

For corporate income tax purposes, this special addition should be made as an *Other* addition on Line 28 of Virginia Form 500. For estates reporting income affected by these federal changes, this special addition should be made as an *Other* addition on Line 3 of Schedule 3 of Virginia Form 770. For individuals reporting income from a sole proprietorship or a single member limited liability company, this special addition should be made as an *Other* addition with Code 13 on Line 2 of Schedule ADJ for Form 760.

Also, the JCWAA contains many similar provisions affecting asset depreciation for qualifying property used in the New York Liberty Zone. If a Virginia taxpayer's 2001 FTI or FAGI was altered due to these provisions, the taxpayer should use the same procedures outlined above for calculating the special addition.

Pass-Through Entities

Any taxpayer who must report income from an S corporation, partnership, limited liability company or other pass-through entity that was computed with the inclusion of the special 30% depreciation allowance or the increased limit on depreciation for a vehicle used for business purposes would be required to make a special addition. This special addition must be computed by the pass-through entity and reported to its owners in proportion with the owners' share of the income from the pass-through entity. The same procedures outlined above should be used for the calculation of this addition. Each shareholder must then add back his or her appropriate share of the addition as an *Other* addition on his or her appropriate Virginia income tax return.

For S corporations required to file a return with Virginia, this addition should be reported as an *Other* addition on Line 2 of Part II of Virginia Form 500S. Partnerships and limited liability companies and others that file as partnerships would report the add-back in the same manner as they currently report other Virginia modifications to partners and members.

Certain Discharges of Indebtedness for S Corporations

Under the JCWAA, a debt that is discharged when the S corporation is insolvent or bankrupt is excluded from the S corporation's income and does not increase the shareholder's basis in the stock of the S corporation. As a result of fixed date conformity, shareholders of stock in an S corporation will be allowed to increase their basis, for Virginia purposes, by the amount of the discharge. This increase in basis could allow shareholders to subtract a suspended loss in determining Virginia taxable income that was otherwise not recognized for federal purposes. Reporting such a loss would be reported as a special subtraction. For S corporations required to file a return with Virginia, this subtraction should be reported as an *Other* subtraction on Line 5 of Part III of Virginia Form 500S. Shareholders of stock in the S corporation would report this subtraction as an *Other* subtraction with Code 99 on Line 6 of Schedule ADJ for Form 760.

Five-year Net Operating Loss (NOL) Carryback

In addition, the JCWAA provides that the carryback period for NOLs arising in taxable years ending on or after January 1, 2001, and before January 1, 2003, will be increased from two taxable years to five taxable years. Taxpayers will be permitted to make an irrevocable election to waive the five-year period and adhere to the existing carryback periods.

Pursuant to Virginia's fixed date conformity provision, a federal NOL may be carried back up to two taxable years and then forward for up to 20 taxable years as an adjustment to FTI or FAGI unless the taxpayer makes an irrevocable election to waive the carryback period.

While these provisions will not effect the computation of a federal NOL for the 2001 and 2002 taxable years, prior and future taxable years to which such an NOL may be applied could be different. As such, taxpayers incurring federal NOLs for taxable years ending on or after January 1, 2001, and before January 1, 2003 will have to track two separate sets of federal NOLs.

However, when FTI or FAGI based on the JCWAA changes result in an NOL that is reported on the Virginia return, an adjustment must be made to determine the amount of the NOL available. For the 2001 taxable year, the *Other* addition resulting from the JCWAA provisions will have to be added to the FTI or FAGI reported on line 1 of the Virginia return in order to determine the amount of the federal NOL available to be carried back for Virginia income tax purposes.

> **Example 2**: For its 2001 taxable year, T, a corporate taxpayer, has FTI of $75 before applying its depreciation allowance. T purchases property in November 2001 with a basis of $1,000. Under MACRS, T is allowed a 10% depreciation deduction on the property on its 2001 return.
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> Under the JCWAA, T's depreciation deduction would be $370 [$1,000 * 30% plus ($1,000-$300)*10%]. As such, T's FTI would be ($295) [$75 - $370]. The NOL of ($295) could be carried back five taxable years for federal income tax purposes.
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> Under the IRC as it existed on December 31, 2001, the depreciation deduction would be $100 [$1,000 * 10%]. As such, T would report the federal NOL of ($295) as its FTI on its Virginia return and make an addition of $270 [$370 - $100]. However, T's federal NOL that could be carried back two taxable years for Virginia income tax purposes would be ($25) [($295) + $270] because the addition resulting from fixed date conformity would reduce the NOL that flowed through from T's federal income tax return.

In some cases, the provisions of the JCWAA may create an NOL for federal income tax purposes while the FTI or FAGI for Virginia income tax purposes will not result in a NOL. **If the *Other* addition resulting from the JCWAA provisions exceeds the amount of the NOL reported for federal income tax purposes, no federal NOL for Virginia income tax purposes will be incurred.** See Example 3. This would be the case even if the computation of Virginia taxable income results in a negative amount. See Example 4.

> **Example 3**: For its 2001 taxable year, N, a corporate taxpayer, has FTI of $275 before applying its depreciation allowance. N purchases property in November 2001 with a basis of $1,000. Under MACRS, N is allowed a 10% depreciation deduction on the property on its 2001 return.
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> Under the JCWAA, N's depreciation deduction would be $370 [$1,000 * 30% plus ($1,000-$300)*10%]. As such, N's FTI would be ($95) [$275 - $370]. The NOL of ($95) could be carried back five years for <u>federa</u>l income tax purposes.
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> Under the IRC as it existed on December 31, 2001, the depreciation deduction would be $100 [$1,000 * 10%]. In computing it's Virginia taxable income for 2001, N would have to make an *<u>Other</u>* addition of $270 [$370 - $100] to adjust for the JCWAA provisions.
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> Under the IRC as it existed on December 31, 2001, N's FTI would have been $175 [$275 - $100] and N would not have had an NOL. Therefore, N will <u>not</u> be allowed to utilize this NOL in a carryback or carryforward for Virginia purposes.
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> **Example 4**: Using the same facts as in Example 3, assume N is also eligible for a $200 subtraction for interest resulting from U.S. obligations on its 2001 Virginia return. With this additional fact, N's Virginia taxable income would be ($25) [($95) + $270 - $200].
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> In this case, even though both the reported FTI and Virginia taxable income are negative, N would not have a federal NOL that could be carried back for Virginia income tax purposes. Just as above in Example 3, the *<u>Other</u>* addition resulting from the JCWAA provisions eliminates the NOL for Virginia purposes. The fact that N's Virginia taxable income is also negative has no bearing on the occurrence of an NOL for Virginia purposes.

Net Operating Loss (NOL) Carryforwards

Federal NOLs incurred for taxable years ending prior to January 1, 2001, may be carried forward to the 2001 taxable year. However, the *<u>Other</u>* addition resulting from the JCWAA provisions will have to be added to the FTI or FAGI reported on line 1 of the Virginia return in order to determine the amount of the federal NOL carried forward from prior taxable years that will be used to reduce FTI or FAGI for Virginia income tax purposes.

> **Example 5**: For its 2001 taxable year, F, a corporate taxpayer, has FTI of $1,100 before applying its depreciation allowance. F purchases property in November 2001 with a basis of $1,000. Under MACRS, F is allowed a 10%

depreciation deduction on the property on its 2001 return. In addition, F has a federal NOL carryforward from 1995 of $800

Under the JCWAA, F's depreciation deduction would be $370 [$1,000 * 30% plus ($1,000-$300)*10%)]. As such, F's FTI would be $730 [$1,100 - $370] before the NOL deduction. For the 2001 taxable year, F would be allowed $730 NOL deduction from the 1995 carryforward. For federal income tax purposes, F would still have an NOL carryforward from the 1995 taxable year equal to $70 [$800 - $730].

Under the IRC as it existed on December 31, 2001, the depreciation deduction would be $100 [$1,000 * 10%]. As such, F would report FTI of $0 on its Virginia return as a result of the 1995 NOL deduction on the federal return. However, an additional computation would be needed to determine the amount of the 1995 NOL that would be applied against 2001 income for Virginia income tax purposes and that amount of the *Other* addition that would be reported on the Virginia income tax return.

The amount of the Virginia addition would be determined by adding F's special 30% depreciation allowance modification of $270 [$370 - $100] to its $730 of FTI before the NOL deduction and subtracting the 1995 NOL carryforward of $800. This would result in F making an addition on its Virginia income tax return of $200 [$270 + $730 - $800]. Notice that the entire 1995 NOL carryforward is used up in the addition computation. As such, for Virginia income tax purposes, F will have no federal NOL carryforward.

Victims of Terrorism Relief Act of 2001

In addition to the changes to the calculation of 2001 FAGI made under the JCWAA, the "Victims of Terrorism Relief Act of 2001" also made changes to the calculation of 2001 FAGI. Specifically, certain items normally classified as income for federal income tax purposes, such as certain death benefits or payments by charitable organizations or cancellations of indebtedness paid or cancelled as a result of a specified terrorist or anthrax attack, were specifically excluded from income. If any of these items were excluded by a taxpayer in the calculation of their 2001 federal adjusted gross income, each item must be added back in the calculation of Virginia taxable income. This addition should be made as an *Other* addition with Code 13 on Line 2 of Schedule ADJ for Form 760.

Other Effects of the JCWAA and the Victims Relief Act

In addition to the potential effects of the JCWAA and Victims Relief Act discussed above, these provisions may also have an indirect material effect on the taxpayer's calculation of 2001 Virginia taxable income. Potential examples of indirect effects of JCWAA and Victims Relief Act provisions are the differences in treatment of passive income and differences in the limitation for deductions of charitable contributions by corporations. If an item such as these are affected, then the taxpayer should then make the appropriate adjustment, either an *Other* addition or subtraction, to adjust for the difference so that the net effect allows the taxpayer to report their 2001 Virginia taxable income consistent with the IRC as it existed on December 31, 2001. The taxpayer should provide a schedule with their income tax return showing the calculation of the *Other* addition or subtraction by showing the difference between the current calculation of the affected item and the calculation of the affected item under the IRC as it existed on December 31, 2001.

Taxable Years Beyond 2001

This tax bulletin is only intended to address the treatment for these provisions for the 2001 taxable year. The department will address the effect of these modifications on future taxable years and prescribe a process for those future taxable years in future releases. In the future, all updates on fixed date conformity will be published on the department's website at http://www.tax.state.va.us. We encourage you to check the site regularly for additional information on this issue.

If you have any additional questions, please contact us at (804) 367-8037.